

Something to Think About



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COMMON CENTS

To read the headlines, you would assume the French Presidential election and the Administration's sacking of Jim Comey as the Director of the FBI were the big stories for the week. However, both were sort of non-events for investors, or should be. First, the French election was basically a foregone conclusion. The issue wasn't whether Macron would win, as everyone expected he would. The bigger issue was by how much he would win. It was an appropriate amount to suggest the status quo would remain the status quo, if you catch my drift.

As for Comey, I have been doing this a pretty long time, and I can't remember an instance when the Director of the FBI was a topic of serious consideration or debate for investors. They are generally not in a position to directly impact corporate profitability, let alone monetary or even fiscal policy. Certainly, you can make some 'slippery slope' arguments, and take the ramifications of Comey's firing to an illogical conclusion. However, where the rubber meets the road, this was/is more of a political story, as opposed to either economic or financial.

So, what was the big news?

Lost in shuffle were the earnings reports of some old-school, retail heavyweights. J.C. Penney (JCP), Macy's, Dillard's, and Kohl's, basically the last of the publicly traded, significant, anchor department stores, with the exception of Sears, all announced their 1Q earnings. I will cut to the quick: the numbers weren't great, particularly for JCP and Macy's. Kohl's and Dillard's were arguably better than you might have expected, even if only in private. Even so, the markets have taken the sector out back this week, quite possibly more than the results would warrant. Actually, you can strike the phrase "quite possibly."

More than the actual numbers, investors fear for the future of anchor department stores due to perceived changing consumer preferences. As such, if the numbers aren't great now, they are going to be even worse in the future. What is the old expression: get while the getting is good? I suppose good is a relative term.

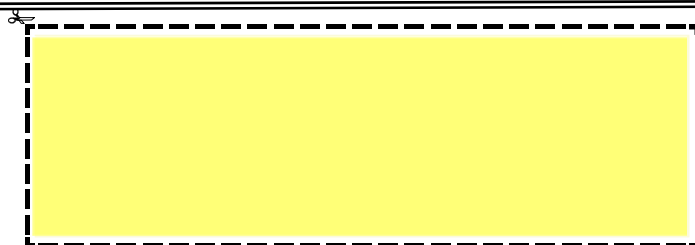
In aggregate, the retail sector seems to be tacking a shellacking in 2017, and companies are trimming locations with a renewed sense of urgency. Some have taken to calling it something along the lines of 'the death of retail,' but I personally think that is a hasty judgement. Retail isn't dead, the US economy simply has too much of it, or at least locations and firms essentially selling the same thing.

Take hhgregg which is, or should I say was, a stand alone retailer of brand name consumer electronics and household appliances. That is simply enough, right? However, what does hhgregg sell that I/you/we can't purchase elsewhere? I almost defy you to come up with something. In truth, I would have to physically, and willingly, drive past a Walmart, Sam's Club, Target, Best Buy, Home Depot, and a Lowe's in order to get to the hhgregg currently closest to my house. These are all much larger companies/retailers, which would imply greater economies of scale and, therefore, potentially lower prices OR the potential to have lower prices. Heck, I can shop on the Internet for just about all of the same stuff, and have the retailer ship it to me....maybe even for free!

That is the real problem with the US retail sector: too much of a good thing or, should I say, too

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much of the same thing. There is no shortage of [stuff] and the places that sell it. In that regard, US retailing is growing through a similar crisis as the banking sector.

Not so long ago, it seems everyone was forecasting the death of the US bank branch. To be sure, I am bearish on the matter, and strongly believe the US will have far fewer of the things in the future. With that said, I also believe 'we' will always have the things, as they will continue to serve a purpose. As such, the death of the US branch banking model will come from the proverbial 1,000 cuts, as opposed to a quick, fell swoop. The reasons are many, but I believe the biggest is some segment of people will always want the perceived permanence of going 'to the bank' to conduct their financial transactions. After all, a lot of people tend to get emotionally attached to their money.

Currently, there are roughly 80,000 bank branches in the United States. Personally, I believe that is probably twice what the economy truly needs, but I haven't done the math. In all probability, absent a financial system collapse like the one in 2008, we will probably have around 75,000 still around in 10 years. That would be about a 0.65% annualized decline, which would be noticeable but not necessarily emotional. In fact, close to home, 'you' could probably shut down a bank branch or two in Crestline Village and people would muse: "It is about time. I don't see how all those branches were making money anyhow." Indeed.

In essence, it won't or shouldn't have the visceral impact of an empty or dead mall. We all 'know' we are supposedly 'overbanked,' right? So, some rightsizing is probably in order. Why should retail be any different?

Now, as you can imagine, Amazon gets a lot of blame for the recent decline of traditional 'bricks & mortar' retail, which is certainly deserved. However, also to blame are the online options for the companies themselves. To that end, I don't know how many times I have purchased something online from a company with a traditional retail presence.....probably more than I have at amazon.com, scratch the probably. The reason is pretty simple: the online option will ordinarily have a better selection and more in stock of what I would like to buy.

For example, take the local Jos. A. Bank. I feel about Bank's the kind of like the way comedian Jim Gaffigan feels about McDonald's:

Some of those deals they offer are just cruel -- 2 Big Macs for 2 bucks. I drive by, "Well, I don't wanna lose money on this. I'll get 80 of them."

In any event, going to the local store is a real hit or miss proposition for someone roughly my size. Oh sure, there is an ample selection of S and XXL shirts, 48" shorts, and the like. However, if you are, say, 1 standard deviation from the mean (and I am to the right), there is often precious little from which to choose. So, I see what they have in the off sizes, and go home to buy what I like in my size. I can't be alone in doing such a thing, can I?

The end result might be a wash for the company, even if the individual location doesn't benefit. To that end, expect more traditional retailers to ask for, even demand, a zip code at the check out register. This will enable them to allocate their online marketing dollars that much more efficiently, and plan any future locations accordingly...eliminating potential storefront overlap in the process. For instance, there probably isn't any reason to have two locations serving essentially the same fistful of zip codes, and this happens all the time.

Admittedly, some retailers already do this, but not all of them....at least not all of the ones I attend.

Further, and Dollar General seems to do a good with this, retailers will increasingly distance their locations away from a concentration of stores selling essentially the same thing. For instance, going back to hhgregg from the first page: why in the [heck] would a company like that open up a unit literally across the parking from a Best Buy (better recognized brand) and just up the hill from a Home Depot (appliances)? These are bigger competitions with greater economies of scale? While I am certain this might happen somewhere across the country, I haven't seen too many Dollar General stores, again, literally across the parking lot from a Walmart.

Now, but what of anchor stores, like the ones that issued earnings reports this week? Well, there will always be a place for them, just like there will always be a place for post offices and bank branches. However, the US consumer just might not need quite as many of them. Further, these anchors will probably do a better job selecting which designers and

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brands they sell in order to differentiate themselves from the competition.

For instance, there is an mid-sized enclosed mall in my general vicinity with traditional anchor stores on either end. Perhaps not surprisingly, they both sell basically the same national brands of clothing and shoes (Hilfiger, Ralph Lauren/Polo, Columbia, Calvin Klein, Cole Haan, etc.), at least for men. One has a slightly better suit selection, but, for all intents and purposes, there is a lot of overlap, a lot, and an increasing amount of empty space between them.

In a simpler, less competitive time, this might not have been an issue, but it is today. Judging from the foot traffic in this mall the last umpteen times I have been there, I would suspect the one on the far right hand side is the more likely candidate to close....largely due the company have a bigger, better store in relatively close proximity. However, I haven't read the news nor do I have any inside information. It just makes the most sense.

Frankly, the powers that be in Charlotte (Belk), Little Rock (Dillard's), and Cincinnati (Macy's) would be wise to divide the country up into primary 'spheres of influence' to avoid competing with each other head to head in the same mall with much of the same merchandise. Down the scale a little, Kohl's and J.C. Penney should do the same thing.

In the end, retail is changing, but it isn't going away. We will continue to have anchor stores and shopping malls; just not quite as many of them as we currently do. Dead? Far from it, but traditional retail is going to be on a diet for the foreseeable future. Those firms which can differentiate themselves with product, price, or location will be able survive and even thrive. Those that don't will continue to shrink until all that is left is empty real estate on the balance sheet, probably at an inflated appraisal.

THAT was the real story this week...the very visible changing face/scene of traditional retail in the United States. After years of trying like the dickens to keep the proverbial wave off the sand, it would seem both investors and companies are now facing the reality of the situation.

As for French Presidential election, c'est la vie.

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